

MR. WEISBROT: Thank you, Mr. Chairman and members of the Commission. I appreciate this opportunity to testify here. I'm just going to make a couple of points because time is limited. And hopefully we can talk about some of the issues that were raised in the previous panel as well.

Before turning to the causes of the problem of our trade deficit and possible solutions, I think it's worth addressing some of the more common explanations just briefly. First, it's most common to blame the trade deficit on America's low savings rate. Indeed, this argument has been presented in previous hearings.

It's easy to show, as a matter of accounting, how this might occur. I put this in an appendix that you have in front of you. But accounting does not give us a mechanism of causality, and the assumption that it does is a common source of confusion in economics. In the standard savings shortage argument, the mechanism works like this: domestic investment exceeds domestic savings, and so domestic interest rates are driven up. This attracts foreign savings to make up the difference, but at the same time it drives up the value of the dollar, and this gives us a trade deficit. (SEE INSERT 3)

There are several problems with this.

First, the relationship between U.S. interest rates relative to the rest of the world and the value of the dollar is not that strong. We have fairly big swings in the dollar without any corresponding movement in interest rates. So, for example, in 1996 the real interest rate, long-term interest rate, on 30-year treasury, U.S. Treasury bonds, was 3.4 percent. It's just about the same today. And yet the dollar has gone up -- has appreciated against our major trading partners' currencies by more than 16 percent.

It's also important to remember that short term interest rates are controlled by the Federal Reserve and these can affect capital flows as much as long-term rates; and they're also a major determinant of long-term rates. So this other link in the whole savings shortage argument is even weaker; that is, the link between domestic savings (relative to investment) and interest rates.

So you may also recall that from the mid-to-late '80s and into the early '90s it was very popular to argue that our large trade deficits were actually caused by the federal budget deficit, and this was popularized by leading economists at the nation's most prestigious think tanks. But this, we should recognize, is exactly the same argument that we're

hearing today, except now we're talking about private spending rather than government spending driving up interest rates, the dollar, and therefore, the trade deficit. And you don't hear too much about the twin deficit theory anymore, and I would bet that most of the economists who promoted it would like to forget that they said these things, and the reason is very simple.

First the trade deficit declined very sharply from its peak of over three percent of GDP in 1986 to .35 percent of GDP in 1991 without a comparable decline in the budget deficit. And then, of course, in the ensuing years, the budget deficit disappeared altogether and became the surplus of today while the trade deficit made a ferocious comeback. So all along, of course, as you can see also from the figures that I've provided here, the relation between government deficit spending and interest rates is also very difficult to find.

So what is the cause of our trade deficit? I think the simplest explanation for our current problem is we had an enormous run up in stock prices in recent years -- and I'll be willing to talk about this more -- but it's the largest rise in American history.

Price-to-earnings ratios are twice their historic levels, and this attracted a huge influx of foreign

capital. And, of course, this surge in demand for dollar-denominated assets drives up the value of the dollar.

Then there are other forces that have helped hold up the dollar. First of all, the commitment of our own government to a high dollar. And Larry Summers has continued this policy from his predecessor, Secretary Robert Rubin.

The third policy of keeping interest rates higher than necessary also boosts the dollar. The real short-term federal funds rate is 2.65 percent today. I didn't see whether the fed raised the interest rate today while I've been here. But it's actually very high already by historical standards, and the fed has raised interest rates twice in the last year, despite inflation running at 2.6 percent, and very little danger of acceleration.

So I think this is much more plausible and consistent with the evidence, but whatever explanation you want to choose, I think it's extremely important to be clear that it's wrong to assert that as a matter of economic logic that our trade deficit is caused by a savings shortage. This is one possible explanation, but it is one that has to be proven and the empirical evidence is very lacking.

I'm going to skip over this next point and just look at some other policy decisions that I think have contributed to the swelling of our trade deficit, particularly over the last two years and especially with Asia, and these are our government's contribution, first to the onset of the Asian financial crisis, and second to the worsening of that crisis through policies designed by the U.S. Treasury Department and the IMF. And third, the ongoing policy of encouraging exports and export growth by developing countries in Asia and throughout the world.

And by now it's well documented that the proximate cause of the Asian financial crisis was, in fact, the liberalization of capital flows that took place in proceeding years. These policy changes were foisted upon these countries by the U.S. Treasury Department and by the IMF; the IMF is controlled by the U.S. Treasury Department.

And when the Asian crisis began, the government of Japan actually tried to set up an Asian monetary fund to stabilize the region's currencies and obtained commitments from other countries, including China and Taiwan and everyone else in the region, for \$100 billion. And this was before the worst of the financial crisis. And it's quite possible that most of it could have been avoided.

This was in September of '97. And the Deputy Secretary of the Treasury, who is now Secretary, Larry Summers, was dispatched to the region to kill the plan, and he did that. And this, I think, is a very good example. Because they wanted all the bailouts to go through the IMF where they could attach certain conditions. And this is a good example of how the Treasury's efforts to control the financial, industrial and other economic policies of other countries can have a very harmful effect, and one that has boomeranged back on the United States, where the regional depression in Asia became the major contributor to the swelling of our trade deficit in the last two years.

And there are a number of other mistakes that were made by the IMF and Treasury. The fund prescribed its usual medicine, the high interest rates, tightening of domestic credit, fiscal tightening, and this, of course, just exacerbated the whole regional recession and depression and forced these countries to try to export their way out of the crisis. Demand was low there for our exports, and of course, a flood of imports came into the United States, and the net result all contributed to our trade deficit.

Finally, just one last point. The IMF and the World Bank together encourage developing countries to produce for exports, and if you read through any of

their documents, their research on the structural adjustment programs, for instance, that they impose on 75 countries throughout the world as we speak, they consider the increase in imports as the percentage of GDP to be a measure of success of these programs. And I would argue that as long as they do that, and as long as they see the U.S. market as the buyer of last resort for these products, this is going to be a major contributor to our trade deficit. I'll stop there. Thanks.

COMMISSIONER LEWIS: Thank you very much for your presentation.

Mr. Glenn Pascall, University of Washington.

APPENDIX

The standard accounting identity, from the national income accounts, is:

$$S - I = (G - T) + (X - M)$$

where

S = private savings

I = gross private domestic investment

G = government purchases of goods and services

T = taxes

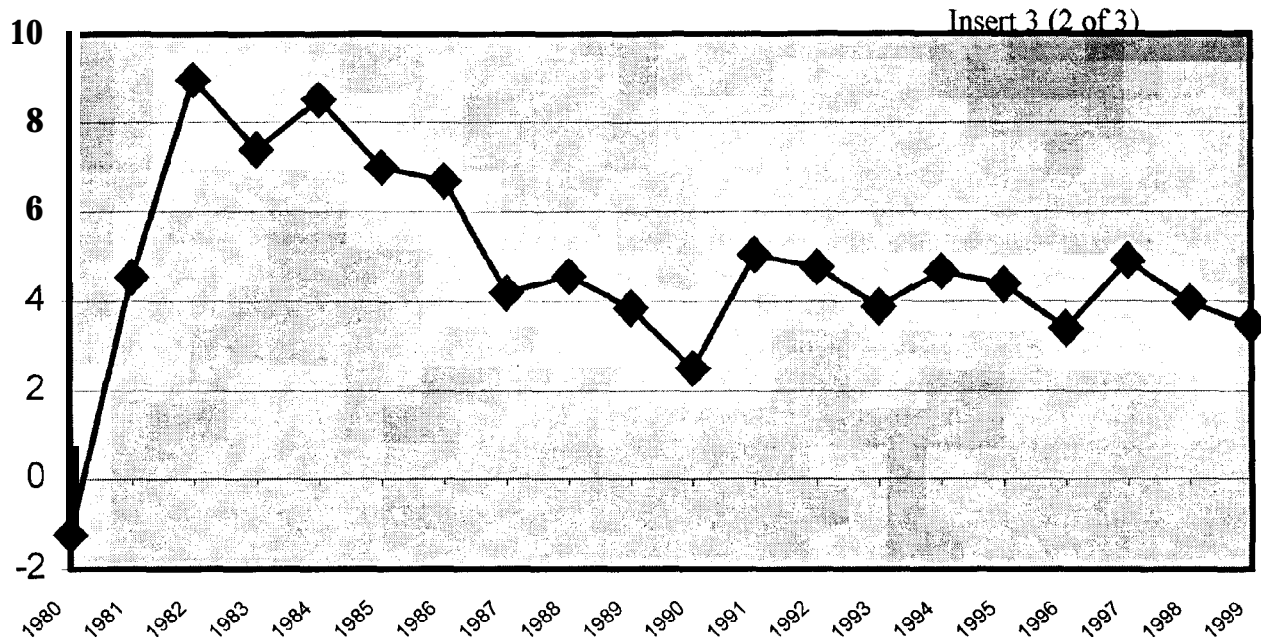
M = imports of goods and services

X = exports of goods and services

From this identity it is clear that if investment increases relative to savings, and the government budget deficit (G-T) remains the same, then the trade balance (X-M) must worsen. The same identity can also be used, as it was in the mid to late **1980s**, to show that if the government budget deficit increases and there are no changes in S or I, the trade balance must also worsen.

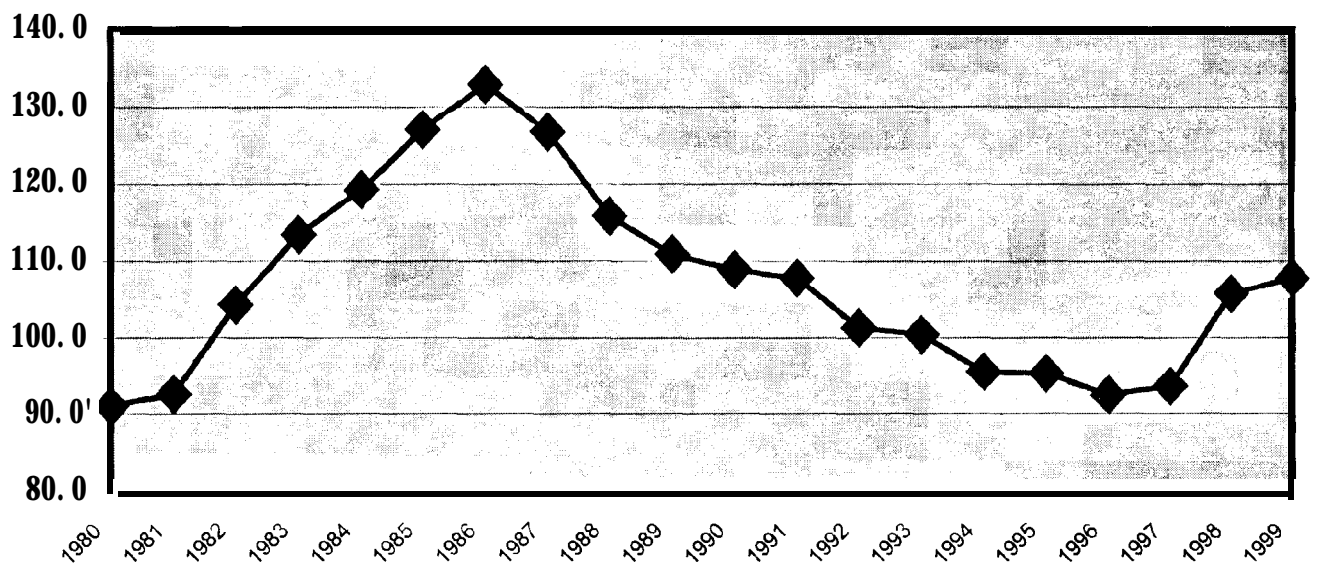
This accounting identity is often misused to state that the Federal budget deficit, or low private savings, has caused the trade deficit to increase. However, as explained in the text, the accounting identity itself says nothing about causality, and there are other, more plausible stories that are consistent with it: for example, a run-up in domestic stock market values can cause foreign financial inflows to swell, raising the value of the dollar (while causing households to save less), and worsening the trade balance.

Figure 1A: Real Interest Rate (30-year Treasury Bond)



Sources: 1999 Economic Report of the President, Tables B-63 and B-73; Salomon Smith Barney; Bureau of Labor Statistics (<http://www.bls.gov/news.release/cpi.nws.htm>)

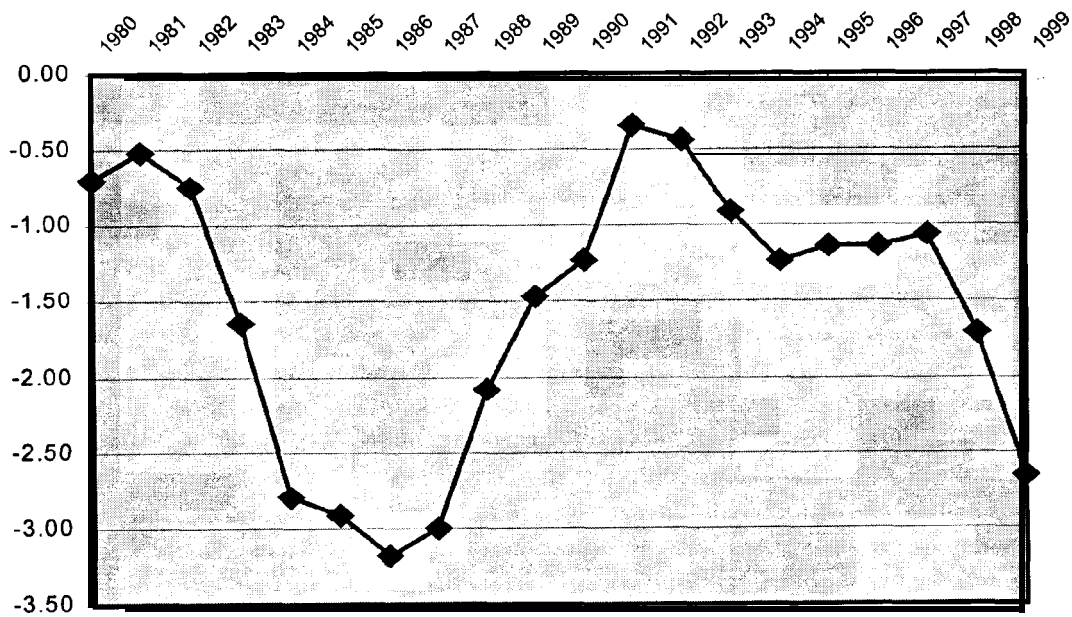
Figure 1B: Trade-Weighted Value of the U.S. Dollar (OITP index/March, 1973=100)



Sources: 1999 Economic Report of the President, Table B-1 10; Board of Governors of the Federal Reserve System (http://www.federalreserve.gov/releases/H10/Summary/indexoc_m.txt)

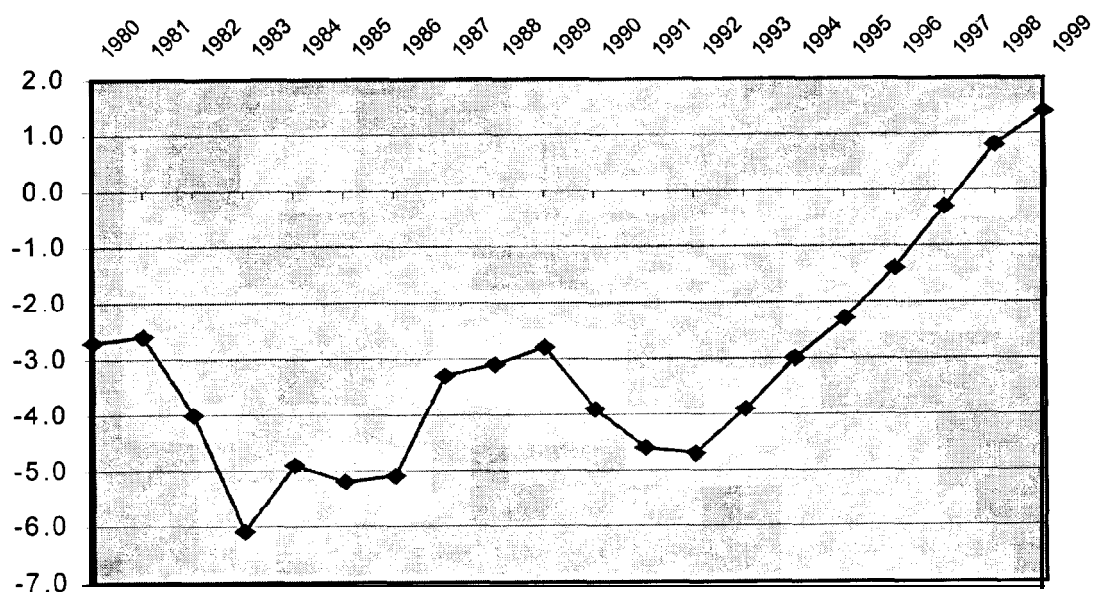
Figure 1C: U.S. Trade Deficit (Percent of GDP)

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Sources: 1999 Economic Report of the President, Tables B-I and B-I 03; Bureau of Economic Analysis (<http://www.bea.doc.gov/bea/newsrel/gdp399at.pdf>)

Figure 1D: Federal Budget Deficit (Percent of GDP)



Sources: 1999 Economic Report of the President, Table B-79; Year End Statement, Fiscal 1999, Secretary of the Treasury and Office of Management and Budget